

Is Capitalism Unfair?

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You've probably heard the old quip that says that unless everyone is identical, equal treatment inevitably produces unequal outcomes, and forcing equal outcomes inevitably requires unequal treatment.

This quip might be old, but its underlying logic is compelling. This quip also highlights an important distinction between two very different ways of thinking about fairness.

The first is thinking of fairness as receiving equal treatment – what one might call fairness as process. The second is thinking of fairness as receiving an equal payoff – what one might call fairness as outcome.

Today I am going to argue that capitalism is fair both in terms of process and in terms of outcomes. Then I shall explain why capitalism is indeed more than fair even by the sense of fairness embraced by those who are most likely to disapprove of capitalism.

Capitalism is fair by the “fairness as process” standard

Most advocates of capitalism view differences in material wealth in free market societies as an inevitable byproduct of the fact that there are differences in talent and differences in tastes as they relate to effort, investment, and risk taking. In a world in which the rules of the game are fairly enforced, these differences inevitably produce different levels of success.

Advocates of capitalism don't just contend that capitalism is fair by the “fairness as process” standard – they believe capitalism simply won't work if people can't count on equal treatment under established laws and institutions. Without equal treatment – the rule of law – everyone has to worry about those in power changing the rules of the game to engage in opportunism to benefit government officials or political cronies. This destroys the incentives that animate capitalism.

Capitalism is fair by the “fairness as outcome” standard

Many on the left, social justice advocates in particular, believe that unequal outcomes are inherently unfair even if they can't identify anything that was unfair about the process that produced the outcome. For them, unequal equals unfair.¹ I will now turn to explaining why capitalism is fair even by the “fairness as outcome” standard.

Economics is all about cooperation. Economists do not say this often enough. I submit that capitalism has been so spectacularly successful at supporting human flourishing because it does a better job supporting cooperation than any other economic system.

An example of cooperation

Suppose that working alone I can make 10 units of something while you can also make 10 units of it, but if we cooperate we can make 26. In this case the value of the whole is clearly greater than the sum of the parts. The difference between the whole and the sum of the parts, here 6, is known as the *cooperative surplus*.

The cooperative surplus is what impels us to voluntarily cooperate with others because it makes it possible for everyone to enjoy a higher payoff. Cooperative surpluses are also the key to increasing general prosperity because they give rise to having more goods and services with no more people. The real key to increasing prosperity is piling up cooperative surpluses.

So where do cooperative surpluses come from?

Cooperative surpluses arise from all kinds of cooperative synergies. Sometimes these synergies are very fundamental. Anyone who has ever moved a sofa knows that two people are far more productive than twice one. But most cooperative surpluses arise from gains from specialization effectuated through the division of labor.ⁱⁱ

Now if you and I cooperate in some way, a natural question is how the output should be divided to produce a fair outcome. To answer this question, let's first think about dividing the cooperative surplus.

Obviously the cooperative surplus is neither yours nor mine – it is *ours*. As such, neither of us has a stronger claim to it so there is no compelling argument for any division of it other than an equal split. There are a number of strong arguments for why this is a compelling social norm. Of course splitting the surplus equally would certainly comport with the moral sensibilities of any social justice advocate.

How should the other 20 units be allocated?

The other 20 units are the sum of the 10 units we each could have produced while working alone. These 10 units are our respective opportunity costs of cooperating. For the final outcome to be fair, everyone must be compensated for their opportunity cost. This makes everyone whole, so the burden of making the output is shared equally.

Consider air travel reimbursement for this conference. No one would think that reimbursing everyone the same amount, say the average air fare, would produce a fair outcome since some had to pay more for their tickets because they had farther to travel. Think of it this way. If fairness is all about equality, so inequality is bad, then inequality should also be bad with respect to bearing an unequal amount of the burden, too.

So a fair outcome by the fairness as outcome standard requires apportionment of the final output according to the following rule: we each get our opportunity cost plus an equal share of the surplus. In my example we should each get 13.

In this example an equal split of the surplus coincides with an equal split of the final output, but that's not normally the case. Let's now consider a more realistic example.

Another example of cooperation

Now suppose that, working alone, I make 2 while you make 10, but when we cooperate we make 16. In this case the surplus is obviously 4. By the output sharing rule above, I should receive 4 units (2 to cover my opportunity cost and 2 for my half of the surplus) and you should receive 12.

Your payoff is 3 times larger than mine. But even so, this is indisputably fair even by the fairness as outcome standard. Why?

Since we are both compensated for our opportunity cost, the net burden of production is equally shared. At the same time, the surplus that belongs equally to both of us is equally shared.

Think of it this way. From your point of view, anything less than 12 would be clearly unfair. You would either fail to cover your opportunity cost so you bear an unfair amount of the input burden or you would fail to get an equal share of the surplus.

Now I might try to bully you into giving me more by insisting that it's not fair for you to get three times more than I get. Such bullying often works, but not because you getting 12 is truly unfair. It works because third parties are more likely to observe differences in final output than to observe differences in input.

Unfortunately, not paying attention to the whole story produces a bad deal for everyone. Suppose my bullying works so there is now a rule that says final output must be split evenly no matter what. In that case we'd each get 8 units. But since you can make 10 on your own, you would never *voluntarily choose* cooperate with me just to get 8.

That means that if you are free to refuse to cooperate with me, then the surplus of 4 will never materialize so total output per capita will not rise. The result is everybody loses. I go from getting 4 to getting 2 and you go from getting 12 to getting 10.

This problem can be solved by forcing you to cooperate with me while accepting a payoff of 8. But in that case we should be clear that the cost of doing so is either less prosperity because you choose not cooperate with me or less freedom because you are forced to cooperate with me against your will.

So my first big claim is that paying people their opportunity cost plus an equal share of the surplus satisfies the fairness as outcome standard. My second big claim is that capitalism is therefore fair by the fairness as outcome standard because it drives us to these kinds of solutions.

How does capitalism do that?

Capitalism endorses honest competition and voluntary transacting. This means that everyone must be paid their respective opportunity cost or they will refuse to cooperate. It also means that the surplus is automatically driven to being divided equally because competition between

transaction partners drives everyone to the same strategy: everyone only offers and only accepts deals to equally share cooperative surpluses. What's more, the more competitive all markets are, the truer this is.

So once we understand that cooperation normally involves different levels of input contribution, it is clear that capitalism is inherently fair by the fairness as outcome standard. It is also clear that splitting final output equally is normally unfair by this standard; a standard of fairness favored by many on left, especially social justice advocates.

Why capitalism is more than fair

Recall that in our second example you received 12 while I received 4. On the surface that looks unfair. But the truth of the matter is that this outcome is more than fair to both of us.

Fairness as process requires that we are both subject to the same rule of apportionment, and we indeed are. At the same time, you effectively put in 10 and take out 12 while I put in 2 and take out 4. By the fairness as outcome standard, this is more than fair to both of us.

To see why, suppose I offer to give you a 5 dollar bill for a 5 dollar bill. This is clearly fair by fairness as outcome standard. Now suppose I offer to give you a 10 dollar bill for a 5 dollar bill. This is obviously a more than fair outcome for *you*.

My final claim is that capitalism is more than fair for *everyone* because it let's *everyone* take more out of the system than they put in. This is possible because of the cooperative surpluses that impel free market behavior in the first place. When everyone is compensated for their opportunity cost (which happens with voluntary transacting under competition) and everyone gets part of the cooperative surplus, everyone necessarily gets more out than they put in.

This isn't a mere theoretical argument. It is perfectly consistent with well over a century of empirical evidence from around the world. Virtually everyone knows it is better to be a poor person in a capitalist society than to be an average person in a centrally planned one.

So the argument for why capitalism is fair is both simple and compelling, and the historical evidence clearly supports it. So why is the inherent fairness of capitalism so hard for so many to see?

The manna fallacy

It's easy to infer cause and effect relationships associated with production in a simple society of farmers and craftsmen who trade just a few goods. This is why most people think pretty clearly about work and reward in such societies. But most people have no theory for where goods and services come from in large, complex, free market societies.

Lacking any such theory they, when thinking about economic issues, implicitly assume that aggregate output is fixed without even realizing it. Indeed, what other assumption could they possibly make? This produces what I call "the manna fallacy."

Recall that in the book of Exodus the Israelites were fed by manna from heaven. This was a miraculous gift from God that had nothing to do with relative input contributions. As such, no one had a stronger claim to any of it than anyone else. To split it any way other than equally would have been unfair and ridiculous.

But if society's goods and services are thought of as manna from heaven, then their apportionment is effectively a zero-sum game. This means that if I get more, then you or someone else necessarily gets less. In such a world it is indeed impossible for everyone to get more out than they put into the system all at the same time. Luckily, that's not capitalism.

Capitalism is abuzz with positive sum activity that is occasioned by the same cooperative surpluses that make it possible for all of us to take out more than we put it for each and every transaction we choose to enter into. So capitalism isn't just fair as process and also fair as outcome – it's more than fair to everyone any way you slice it.

In my view the manna fallacy leads to confusion about how the world actually works and therefore wrong conclusions about fairness and justice as it relates to free market economic activity. This has led to wars, revolutions, and foolish policies even in thriving capitalist societies around the world over the last century.

Let me close with a suggestion. The next time you find yourself talking to friends, colleagues, or students who criticize capitalism because it is so obviously unfair, ask them why they aren't more interested in being fair about the input side of things. Then ask them how they would divide an output of 16 made by the both of you, with you having contributed 2 while he or she contributed 10. Let them see for themselves that equal splitting of the final output either reduces everyone's welfare or someone's freedom. Perhaps by reminding them that in today's world goods and services are not manna – they must be produced through cooperative activity – you might clarify their thinking.

ⁱ Not all social justice advocates are this simple-minded. John Rawls, who was perhaps the 20th century's leading proponent of social justice through his "justice as fairness" doctrine, certainly did not advocate final output being evenly split in all circumstances.

ⁱⁱ See Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776).